How can pension plans be sure they choose the right transition manager?

The use of Transition Management services continues to increase but how can pension plans ("Plans") be sure that they have chosen the right provider?

The frequency and complexity of Plan restructuring and manager changes are increasing given the pressure on Plans to improve the efficiency and performance of their investments.

The costs and risks incurred in executing such changes are well documented, as is the general acceptance that the use of a transition manager can help ease the pain of implementation. The growing number of transition managers means there is considerable choice for Plans; however, this raises the problem of how a Plan can gain comfort that it has fully reviewed the wide range of services and selected the best provider for its transition.

There are a number of issues a Plan must consider when selecting a transition manager.

The Manager should have the requisite knowledge, experience, expertise and trading capability to accommodate the mandate for which the transition manager is being hired. If the transition involves multiple asset classes, the transition manager should have the skills to offer the best execution, strategy design and implementation solutions to satisfy the situation.

A transition manager's ability to monitor and control operational risk is also a key consideration. A Plan should consider whether a transition manager: (i) has established links to custodians; (ii) can demonstrate operational efficiency; (iii) has robust systems for coordinating and managing operational risk and the settlement process.

Prior to appointing a transition manager, a Plan should be comfortable with the manager's business model, that is, how it is organized, who will the client speak to on a day to day basis, is the team sufficiently resourced and budgeted accordingly with appropriate leadership to execute its mandate.

It is also essential for a Plan to be able to determine the success of a transition upon completion, and given the increasing complexity of transitions, this can be a difficult exercise. In that regard, it is especially important to distinguish between the performance of the Plan's assets and the performance of the transition manager.

Performance Measurement and Transaction Cost Analysis can often be confused when assessing the quality of a transition. Performance Measurement is used to measure the returns of the various Plan funds over a period of time. The information that is gleaned gives insight as to whether a given fund manager is adding alpha and implementing what has been agreed. By way of contrast, Transaction Cost Analysis seeks to measure the effectiveness of trading strategies used in the transition.

As understanding of transaction costs has grown, the realization that high costs may be incurred during re-organizations has also grown. This has been one of the main drivers behind the growth of Transition Management and the almost mandatory appointment of specialist transition managers for carrying out restructuring on a Plan's behalf.

As understanding and use have increased the need to measure and compare the effectiveness of different transitions, transition managers and approaches have also increased. This has led most recently to the introduction of the T-standard.

The T-Standard is much debated, as people try to agree on a common approach for measuring transitions. It seeks to compare the actual value of the assets at the end of the transition with the theoretical value of the assets, assuming that the transition had been carried out instantaneously and cost free at the start of the transition. A limitation of the T-Standard approach is that instantaneous trading is not possible. Hence, there is a need to evaluate the effectiveness of the transition not only from a strategy and implementation perspective, but also the given effect the transition period had on the ability for the new managers to generate alpha.

The transition manager is responsible for trading and does its job well through incurring minimal market impact and opportunity costs in the process. This is crucial as the Plan may incur trading volumes usually experienced over extended periods in a matter of days or a week. So how does a Plan determine whether the job was well done?

In an ideal (T-Standard) world, the Plan would reorganize all its assets instantaneously. Liquidity, however, is not infinite and, consequently, trading quickly incurs adverse market impact costs. To reduce this, trading should be carried out over a period of time. This reduces market impact, but given market and individual stock volatility, opportunity costs will increase. Reaching the right balance is one of the key skills in delivering a successful transition. The need to find liquidity determines how to design the appropriate trading strategy.

Every transition is different, not only in terms of size, liquidity and market conditions, but also structure, risks and complexity. Each transition will require its own optimal implementation strategy, and each of these will have its own pre-trade cost estimate. In part, it is the adjustment for trade difficulty that is essential for determining whether a transition was implemented effectively.

While the Plan sponsor will expect the transition manager to execute the Plan's mandate, it is not the transition itself that is creating alpha. Alpha is generated from the ongoing fund management process. Designing a performance measurement approach to evaluate transition activity is not the correct approach; transitions are a very intensive trading activity that require evaluation from a trading and risk perspective. Only with a clear framework for discussion and agreement as to the implementation strategy, understanding of transition difficulty and approach to measurement, between the Plan and its transition manager, will a successful transition be delivered.

Selection of the wrong transition manager can have a direct cost impact on the value of the Plan's assets. However, Plans can gain comfort that the process of making the right choice is a challenging but doable task, provided that the right questions have been asked and a suitable number of providers reviewed. Meaningful measurement of the transition manager's performance is also possible, but understanding of what should be measured and how this will be reported should be discussed and agreed with the transition manager prior to the transition.

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